United States Court of Appeals

for the Second Circuit

APPELLEE'S BRIEF

75-7030

To be argued by:
BARRY H. GARFINKEL

United States Court of Appeals
For the Second Circuit

Docket No. 75-7030

FRIGITEMP CORP., GERALD LEE, GERALD ROSS, HENRY GUTMAN and LEON GUTTMAN,

Plaintiffs-Appellants,

against

FINANCIAL DYNAMICS FUND, INC., FINANCIAL INDUSTRIAL FUND, INC., FINANCIAL VENTURE FUND, INC., FINANCIAL PROGRAMS, INC., ROBERT E. ANTON and JOHN M. BUTLER,

Defendants-Appellees.

ON APPEAL FROM THE UNITED STATES DISTRICT COURT FOR THE SOUTHERN DISTRICT OF NEW YORK (TENNEY, J.)

BRIEF FOR DEFENDANTS-APPELLEES

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Defendants-Appellees.

On Appeal from the United States District Court for the Southern District of New York (Tenney, J.)

BRIEF FOR DEFENDANTS-APPELLEES

Issues Presented for Review

1. Did the District Court* below correctly dismiss the common law and federal securities claims asserted

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* The District Court's memorandum opinion is reported at [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,907, and is set forth in the Appendix at 188a. [Hereinafter, the Appendix will be referred to as A __.]

by Frigitemp Corporation ("Frigitemp") against appellees allegedly arising from open market purchases and sales of Frigitemp stock by certain of the appellees who were not in a fiduciary relationship to Frigitemp and where Frigitemp had made no open market purchases or sales of its own stock during the relevant period?

2. Did the District Court below correctly dismiss the common law and federal securities claims asserted by the individual appellants, who are the principal executive officers and major shareholders of Frigitemp, based upon alleged nondisclosures concerning the Frigitemp shareholdings of appellees and their intentions to purchase Frigitemp stock?

Statement of the Case

This action was commenced on March 25, 1974 by Frigitemp, a New York corporation, Gerald Lee ("Lee"), President and the majority shareholder of Frigitemp, Gerald Ross ("Ross"), Vice-President, Treasurer and a major shareholder of Frigitemp, Henry Gutman and Leon Guttman (the "Guttmans"), each an employee and a substantial shareholder of Frigitemp. The defendants are three Denver-based mutual funds, Financial Venture Fund, Inc. ("FVF"), Financial Industrial Fund, Inc. ("FIF") and Financial Dynamics Fund, Inc.

("FDF") (collectively referred to as the "Funds"), Financial Programs, Inc. ("Financial Programs"), a Denver-based corporation which manages the Funds, and Robert E. Anton ("Anton") and John M. Butler ("Butler"), officers of the appellee corporations. Federal jurisdiction is allegedly based upon diversity of citizenship of the parties and on § 10(b) of the Securities Exchange Act of 1934.

A. The Complaint*

The complaint alleges four claims for relief: two on behalf of Frigitemp and two on behalf of the individual appellants, Lee, Ross and the Guttmans.

The complaint alleges that subsequent to an initial public offering made by Frigitemp in January 1969 (the "Public Offering"), from March 1969 through March 1970 the appellees engaged in a conspiracy to cause the Funds to purchase in the open market a total of 142,100 shares of Frigitemp common stock, all but a small part of Frigitemp common stock then available to the public. (Complt. ¶¶ 13, 14) As a result, it is alleged, the price per share increased from $15.25 to $37. (Complt. ¶ 15)

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* The complaint is in the record at A 4a.

It is also alleged that on August 29, 1969, after the open market purchases began, FVF purchased from Frigitemp $1,000,000 principal amount of 5% convertible subordinated debentures together with warrants to purchase 50,000 shares of Frigitemp common stock at prices between $17 and $19 per share (the "Private Placement"). In connection with the Private Placement, appellees together with certain other persons, are said to have acquired from Frigitemp certain "material, confidential and 'inside' information concerning the business and affairs of Frigitemp." (Complt. ¶ 17) The Funds are alleged to have made their open-market purchases on the basis of this "confidential and inside" information. In February and March 1970, defendants FVF and FDF are alleged to have sold approximately 18,000 of their shares of Frigitemp stock for a profit of $130,000. (Complt. ¶¶ 24, 25) In 1971, it is alleged that the Funds sold another 123,000 shares of their Frigitemp stock, thereby depressing the price of the stock to $8.00 per share. (Complt. ¶ 27)

The complaint further alleges that, as a condition of the Private Placement, appellees FVF, Financial Programs and Anton and Butler "required" Lee, Ross and the Guttmans to contribute an aggregate of 100,000 shares of Frigitemp stock to the capital of Frigitemp, thereby reducing by that number the shares of Frigitemp stock then outstanding. (Complt. ¶20)

In "requiring" that this contribution be made, it is alleged that appellees failed to disclose the following material facts:

> "(a) that defendants were causing and had caused The Funds to acquire all but a small part of the shares of Frigitemp available to the public:
>
> (b) that the condition that Gerald Lee, Gerald Ross, Henry Gutman and Leon Guttman contribute to the capital of Frigitemp 100,000 of its outstanding shares of common stock then held by said plaintiffs, was intended to reduce the number of shares outstanding by that number and cause an immediate increase in earnings per share and book value per share for the 142,100 shares of Frigitemp's common stock then owned by and to be acquired by The Funds." (Complt. ¶ 21) (Emphasis added)

The complaint further pleads that had Lee, Ross and the Guttmans known of the facts stated above, they would not have contributed 100,000 of their Frigitemp shares to its capital. (Complt. ¶ 23)

The complaint seeks on behalf of Frigitemp (i) to recover all profits realized by appellees in connection with the purchases and sales of Frigitemp stock (alleged to have been $130,000) on the theory that such purchases and sales constituted "an unlawful manipulation of the price of the shares of Frigitemp," and thus a fraud and deceit under common law against Frigitemp (Complt. ¶¶ 31, 32); and (ii) the same relief on the theory that the purchases and sales of Frigitemp stock on the open market by

the Funds constituted violations of § 10(b) of the Securities Exchange Act of 1934 (the "1934 Act"), 15 U.S.C. § 78j(b), Rule 10b-5, 17 C.F.R. § 240.10b-5, promulgated thereunder, and § 17(a) of the Securities Act of 1933 (the "1933 Act"), 15 U.S.C. § 77q(a).* (Complt. ¶¶ 34, 35)

The complaint seeks on behalf of the individual appellants, Lee, Ross and the Guttmans, damages in the amount of $2,100,000 (100,000 shares x $21.00, the market price of Frigitemp stock as of August 29, 1969) on the theory that the consummation of the Private Placement by FVF while in possession of the above-quoted, non-disclosed "material" information constituted (i) a violation of § 10(b) of the 1934 Act (Complt. ¶¶ 37, 38), and (ii) common law fraud and deceit against the individual appellants. (Complt. ¶¶ 40, 41)

B. Prior Proceedings

On March 28, 1974, three days after this action was filed, the Funds commenced an action in the United States District Court for the District of Colorado (Civil Action No. 74-277) against Frigitemp, Lee, Ross and other Frigitemp officers and directors (the "Colorado action") claiming damages based upon alleged fraud, market manipula-

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* Appellants have abandoned their claim based upon § 17(a) of the 1933 Act. (Appellants' Brief at 3)

tion and violation of the federal securities laws in connection with, inter alia, Frigitemp's Public Offering and the Private Placement.*

On April 30, 1974, the Funds moved in this action (i) to strike the complaint pursuant to Rule 11 of the Federal Rules of Civil Procedure ("FRCP") as sham, not supported by good ground and interposed for delay; (ii) to dismiss the complaint pursuant to Rule 12(b)(6) of the FRCP for failure to state a claim upon which relief could be granted; (iii) to dismiss the complaint pursuant to Rule 9(b) of the FRCP because the circumstances constituting the fraud alleged herein were not stated with the required particularity; or, in the alternative, (iv) to transfer the action pursuant to 28 U.S.C. § 1404(a) to the United States District Court for the District of Colorado.

Thereafter, Financial Programs, Anton and Butler joined in the above motion to dismiss and, in addition,

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* The commencement of the Colorado action followed a proceeding brought by the Securities and Exchange Commission (the "SEC") in March, 1973 against appellants Frigitemp, Lee and Ross and other directors and officers of Frigitemp, and the entry of various consent decrees therein. The complaint in the SEC suit alleged, inter alia, violations of the federal securities laws by appellants Frigitemp, Lee and Ross in connection with the 1969 Public Offering and the Private Placement. (The complaint in the Colorado action is set forth at A 32a; the complaint and the several consent orders in the SEC proceeding are set forth at A 46a.)

Court decision in Superinten-

moved to quash or to stay depositions which had been noticed by appellants to take place in New York. Anton and Butler moved separately under Rule 12(b)(2) to dismiss the complaint as to them for lack of personal jurisdiction.

On June 14, 1974. the District Court granted the motion of Financial Programs, Anton and Butler to stay the depositions pending the determination of the motions to dismiss or to transfer. This order has not been appealed.

C. The Decision Below

The District Court, in a decision issued by Judge Tenney on December 5, 1974, granted appellees' motion to dismiss pursuant to Rule 12(b)(6) with respect to all four claims of the complaint.* (A 188a)

Judge Tenney held that Frigitemp had no standing to sue under common law as a defrauded party, nor could it assert any right to profits which might have been made by the Funds from the purchases and sales of Frigitemp stock, as no fiduciary relationship existed between it and any of the defendants. Moreover, the Court held that Frigitemp had no

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* Thus, the District Court did not rule upon appellees' Rule 11 or Rule 9(b) motions, the § 1404(a) motion to transfer, or the Rule 12(b)(2) motion to dismiss for lack of personal jurisdiction over Anton and Butler.

Neither appellant nor Alleghany,

right of recovery under § 10(b) of the 1934 Act or Rule 10b-5 thereunder as it was neither a purchaser nor seller of securities.

Judge Tenney dismissed the federal claims of Lee, Ross and the Guttmans on the ground that the information allegedly not disclosed to them, which had allegedly "induced" them to contribute their stock to capital, "could not be construed as corporate inside information," (A 196a) and thus the nondisclosure could not provide the basis of a recovery under § 10(b) of the 1934 Act and Rule 10b-5. The individuals' claims for fraud under New York law, based upon the same alleged nondisclosures, were dismissed by the Court on the ground that defendants had no duty to disclose such information.

D. The Facts*

On or about January 15, 1969, Frigitemp made a Public Offering pursuant to the Prospectus which consisted

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* Inasmuch as the facts as contained in the complaint herein must be taken as true for the purposes of a 12(b)(6) motion, the facts presented here have been taken only from the complaint as supplemented by appellants themselves in the court below, together with information from the Frigitemp Prospectus dated January 15, 1969 (the "Prospectus"), which is in the record as Exhibit C to the Funds' motion to dismiss. (A 87a)

of 80,000 shares of common stock, and warrants to purchase and debentures convertible into another 100,000 shares.

Until the Public Offering, Frigitemp was a closely held corporation, with 81.4% of its 829,000 outstanding shares of common stock being held by its four officers and directors. (A 95a, 97a) Fifty-nine percent (59%) of such outstanding shares was owned by the President, appellant Lee, and members of his family. (A 89a) Thus, the securities offered to the investing public in January 1969 comprised only a small proportion of the then issued and outstanding shares of Frigitemp common stock. Even assuming the purchase by the public of all units offered in the Public Offering, Lee and members of his family, alone, would thereafter own approximately 54% of all outstanding shares of Frigitemp common stock, and thus would clearly remain in control of Frigitemp. (A 89a)

In August 1969, a Private Placement was negotiated between Frigitemp and FVF whereby FVF purchased $1 million dollars' worth of that corporation's convertible debentures for cash. As a condition of consummating that agreement, 100,000 shares of Frigitemp stock were contributed to capital. Appellant Lee, "because [he] believed the investment of $1 million in Frigitemp was for the best interests of Frigitemp," agreed, together with Ross, Gutman and Guttman, to meet these terms. (A 140a)

It is further alleged that in the course of negotiating the terms of the Private Placement with Frigitemp, the Funds learned of a variety of "material, confidential and 'inside'" information, principally concerning a program of corporate acquisition which Frigitemp was about to pursue.* (A 7a) The complaint concludes that, while in possession of this "material and confidential" information, appellees engaged in a fraudulent and manipulative scheme to corner the market in Frigitemp's common stock by purchasing, between March 1969 and March 1970, an aggregate of 142,100 shares of such stock in the open market (A 6a, 7a).** However, no facts are alleged, and indeed the extensive supplemental material submitted by appellants provides no facts which might substantiate the conclusionary statements with respect to (i) the

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* Interestingly enough, the information which appellees are alleged to have learned prior to August 29, 1969 includes, according to the complaint, information concerning completed acquisitions by Frigitemp as follows:

(i) "that Frigitemp had acquired on July 28, 1969 the Rath Company . . ."
(ii) "that Frigitemp had acquired in October, 1969 R & H Metal Products . . ."
(iii) "that Frigitemp had acquired on June 16, 1970 Labequipco, Inc. . . ."
(iv) "that Frigitemp had acquired on November 20, 1969 Special Projects, Inc. . . ." (Emphasis added) (A 8a)

** According to Frigitemp's stock transfer records, 98,600 of these shares were purchased prior to August 29, 1969, and 40,500 were purchased after that date (A 150a).

alleged conspiracy, (ii) the alleged "cornering the market" of Frigitemp stock,* or (iii) the alleged manipulation of the market price of Frigitemp stock. (Appellants' Brief at 7)

Assuming arguendo that a case of fraud might be made on the above facts, it is obvious that the only possible persons who might have suffered loss from any such deceit would have been the public investors from whom and to whom the Funds had purchased and sold their Frigitemp stock. However, it is equally clear from the facts as pleaded herein that it was neither the public investors nor appellants who suffered the major losses in these transactions. The Funds allegedly manipulated the market price of Frigitemp stock up and manipulated it right back down again, all to their own aggregate loss of nearly $1.9 million. (A 113a)

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* Appellants claim that the total number of shares of Frigitemp available to be traded publicly during this period was not more than approximately 186,000 shares. (A 141a) According to the Prospectus, if all securities offered in the Public Offering were sold, there would be 909,500 shares of Frigitemp common stock outstanding. (A 90a) (This figure does not include 108,000 shares reserved for issuance upon the exercise of the outstanding warrants and conversion of the outstanding debentures (id.), nor take into account the return to capital of 100,000 of appellants' shares on or after August 29, 1969). There has been no allegation, nor do these figures indicate, that the purpose of the alleged conspiracy was or could be to gain voting or working control of Frigitemp. In fact, no purpose whatsoever has been alleged with respect to the alleged "cornering of the market."

ARGUMENT

POINT I

THE DISTRICT COURT WAS CORRECT IN DISMISSING FRIGITEMP'S CLAIMS AGAINST ALL APPELLEES

A. The District Court Correctly Held that the Facts as Alleged by Appellants Could Not Form the Basis for a Claim by Frigitemp Against Appellees for Fraud or Deceit under Common Law

Both in the Court below and in this appeal, Frigitemp relies solely for its alleged right to recover under common law on the New York Court of Appeals case of Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78 (1969), and its progeny. See Schein v. Chasen, 478 F.2d 817 (2d Cir. 1973), vacated sub nom. Lehman Bros. v. Schein, 416 U.S. 386 (1974); Davidge v. White, 377 F. Supp. 1084 (S.D.N.Y. 1974). Apparently, appellants have resorted to this New York rule which governs corporate fiduciary obligations and liability, because the facts as alleged herein do not and cannot establish the required elements of a common law cause of action in fraud under New York law.*

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* It is by no means certain that Frigitemp's alleged cause of action for fraud would be governed by New York law, as there is no showing that the acts complained of herein (the market purchases of stock by the Funds) took place

(continued)

Judge Tenney categorically rejected appellants' claim under Diamond:

> "Diamond [as] extended by the Schein case, has no applicability to the instant case. The two cases, when read together, merely provide that persons who are not officers or directors of a corporation may be held liable to the corporation for profits made if they are 'co-venturers' of a fiduciary of the corporation, engaged with the fiduciary in a 'common enterprise' to misuse confidential corporate information. Schein v. Chasen, supra, 478 F.2d at 822-23. Since defendants are not alleged to be fiduciaries of

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Footnote continued:

in New York. However, as the elements of neither actual nor constructive fraud under any law have been alleged in the pleadings or briefed by appellants in their appeal, the conflicts of law question is not here at issue.

Under New York law, the five elements essential to sustain a cause of action in fraud are (i) a representation of fact, (ii) which is either untrue and known to be untrue or recklessly made, (iii) which is offered to deceive the other party and (iv) to induce them to act upon it, and (v) which causes injury. Jo Ann Homes v. Dworetz, 25 N.Y.2d 112, 119, 302 N.Y.S.2d 799, 803 (1969); Channel Masters Corp. v. Aluminum Limited Sales, 4 N.Y.2d 403, 176 N.Y.S.2d 259 (1958); Reno v. Bull, 226 N.Y. 546, 550 (1919); See also 24 N.Y. Jur., Fraud and eit, § 14. Constructive fraud has been defined as that "resulting from gross negligence or from admissions, declarations, or conduct intended or calculated, or such as might reasonably be expected, to influence the conduct of the other party and which have so misled him to his prejudice that it would a fraud to allow the true state of facts to be proved. (21 N.Y. Jur., Estoppel, § 26)." Spielbeuhler v. Henry Spielbeuhler Construction Corp., 28 App. Div. 2d 1047, 284 N.Y.S.2d 13, 15 (3d Dep't 1967); see also Finn v. Empire Trust Co., 121 F.Supp. 309, 315 (S.D.N.Y. 1950); Nasaba Corp. v. Harfred Realty Corp., 287 N.Y. 290, 295 (1942).

Frigitemp and since they are not alleged to have acted in concert with a fiduciary of Frigitemp, the theory of liability set forth in Diamond and Schein would not permit Frigitemp to recover any profits defendants may have made." (A 192a) (Emphasis added)

It is clear that Judge Tenney was correct in his analysis of this line of New York cases, and that the rule stated therein affords Frigitemp no grounds for recovery.

In Diamond, a shareholder brought an action on behalf of his corporation against the chairman of the board and president of the corporation charging that defendants, having gained knowledge with respect to a substantial drop in earnings solely by virtue of their executive positions, had sold their stock in the corporation prior to making such adverse information public. The shareholder sought an accounting to the corporation for the difference between the amount realized on the sale and the worth of the stock after the information concerning earnings had become public.

In upholding the complaint, Chief Judge Fuld found that a valid cause of action was stated for breach of fiduciary duty. The Court went to great lengths to set forth the rationale of its holding:

"It is true that the complaint before us does not contain any allegation of damages to the corporation but this has never been considered to be an essential requirement for a cause of action founded on a breach of fiduciary duty.

* * *

"Just as a trustee has no right to retain for himself the profits yielded by property placed in his possession but must account to his beneficiaries, a corporate fiduciary, who is entrusted with potentially valuable information, may not appropriate that asset for his own use even though, in so doing, he causes no injury to the corporation. . . . In our opinion, there can be no justification for permitting officers and directors, such as the defendants, to retain for themselves profits which, it is alleged, they derived solely from exploiting information gained by virtue of their inside position as corporate officials." 24 N.Y.2d at 498, 499, 301 N.Y.S.2d at 81 (Citation omitted) (Emphasis added)

Although the holding in Diamond was extended by this Court in Schein v. Chasen, supra, it is clear that Schein equally provides Frigitemp no grounds for recovery. Schein was brought as a diversity action in the Southern District of New York by a shareholder of a Florida corporation who alleged derivative claims against the corporate president and certain outside investors and stockbrokers for misuse of corporate inside information. An accounting was demanded. Finding that Florida law applied, the district court granted a motion to dismiss as to the outside investors and stockbrokers for failure to state a claim upon which relief could be granted.

On appeal, this Court, stating that its objective was to interpret and apply Diamond "as the Florida Court would probably interpret it" (478 F.2d at 821), reversed the

dismissal. It held that the non-fiduciary defendants, alleged to have been involved with the corporate directors "in a common enterprise to misuse confidential corporate information for their own enrichment" (478 F.2d at 822), were liable to the corporation to the same degree as the directors.

In the case at bar, however, Frigitemp is not suing any of its own corporate officers or fiduciaries, to bring it within the rule of Diamond; and no allegation of any "common enterprise" with a fiduciary of Frigitemp has been or could be made on the facts as stated herein to bring it within Schein. To the contrary, the "inside" information from which appellees are alleged to have profited was given to them directly by the President of Frigitemp, who, acting on behalf of Frigitemp, was engaged in arm's-length negotiations with FVF in order to place $1 million worth of the company's securities. Such information was disclosed by Frigitemp in order to induce FVF to make a substantial investment in Frigitemp, and thus its disclosure was not in violation of any duty of confidentiality to that corporation.

Moreover, the holding of Schein must be read restrictively. The decision itself was a divided one. Circuit (now Chief) Judge Kaufman, in his dissent, noted at length that such an expansive construction of Diamond was unwarranted:

"A careful reading of the Diamond opinion reveals that [defendants'] liability in a stockholders' derivative action was grounded solely in their having breached a fiduciary duty owed by them to [the plaintiff corporation] as corporate officials.

* * *

"Despite the manner in which the majority opinion convolutes the law and the facts in this case, a view that a tippee is cloaked with state law fiduciary obligations to the corporation whose shares he trades is an unknown and untenable legal concept. Neither Diamond -- itself a significant alteration of the common law principles applicable to an officer's or director's trading in his corporation's shares -- nor the law of agency supports such a holding. Nothing in the majority opinion tells us why or on what grounds a New York Court would hold a tippee trader liable to the corporation for his profits under common law fiduciary principles, and the Court exceeds its authority by substituting its own view of what state law ought to be, for what the law actually is." 478 F.2d at 826, 828 (Citations omitted) (Emphasis added)

In addition, on vacatur and remand of the case by the United States Supreme Court, the question of the defendant investors' and stockbrokers' liability under Florida law was certified to the Supreme Court of Florida by this Court. In a decision which quotes the district court opinion at length and Judge Kaufman's dissent practically in toto, the Florida Supreme Court rejected this Court's holding in Schein by stating:

> "Not only will we not give the unprecedented expansive reading to Diamond sought by appellants but furthermore, we do not choose to adopt the innovative ruling of the New York Court of Appeals in Diamond, supra." Schein v. Chasen, Case No. 45,803 (Sup. Ct. Fla., March 13, 1975), 43 U.S.L.W. 2416 (April 15, 1975), BNA Sec. Reg. L. Rep. No. 296 (April 2, 1975) at H-4

Appellants' reliance on Davidge v. White, supra, is similarly misplaced. That case merely holds that, under Delaware law and the principles discussed above, a corporation has the right to recover profits from a defendant who, having gained confidential information while a director and officer, sold his stock shortly after resigning and before such information became public. As stated by the district court:

> "[I]t would be illogical to hold that one who gains confidential information by virtue of his fiduciary capacity, and thereby incurs a fiduciary duty not to profit from such information, is absolved of this duty on the day after his formal resignation as director." 377 F. Supp. at 1089

Frigitemp now urges that this Court expand the rule of Diamond not only beyond its expressed limitations, but beyond the limits of the questionably viable opinion in Schein. Diamond involved only officers' and directors' liability to their corporation; Schein involved the liability to a corporation of tippees who acted in concert with the corporation's directors. Frigitemp here attempts to

impose liability for use of "inside information" on unrelated third parties which dealt with the corporation at arm's length and received such information as a purchaser of corporate securities. Neither the holdings nor the rationale of these cases support such a claim.

B. The District Court Correctly Held that Frigitemp Has No Standing to Sue Under § 10(b) of the 1934 Act

The District Court held that Frigitemp had no standing to sue under § 10(b) of the 1934 Act and Rule 10b-5 thereunder as it was neither a seller nor purchaser of securities. (A 193a) Such holding is fully supported by governing precedents.

Under Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952), standing to sue under § 10(b) is limited to those persons who actually purchase or sell securities. Iroquois Industries, Inc. v. Syracuse China Corp., 417 F.2d 963 (2d Cir. 1969), cert. denied, 399 U.S. 909 (1970); Greenstein v. Paul, 400 F.2d 580 (2d Cir. 1968); Pollak v. Eastman Dillon, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,987 at p. 97,412 (S.D.N.Y. 1975); Cutner v. Fried, 373 F. Supp. 4 (S.D.N.Y. 1974). Although the Birnbaum rule has been critized by com-

mentators,* and although federal courts have fashioned variations thereto,** it remains very much the law in this Circuit. Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 495 F.2d 228, 238 n.15 (2d Cir. 1974); International Controls Corp. v. Vesco, 490 F.2d 1334 (2d Cir.), cert. denied, 417 U.S. 932 (1974); Schein v. Chasen, supra, 478 F.2d at 821 n.5; Davidge v. White, supra, 377 F. Supp. at 1086, 1087; Bolger v. Laventhol, Krekstein, Horwath & Horwath, 381 F. Supp. 260 (S.D.N.Y. 1974).

Appellants attempt to circumvent the long-standing purchaser-seller requirement (i) by confusing allegations of fact with respect to the securities transactions involved, and (ii) by arguing that the purchaser-seller requirement has recently been modified by the Supreme Court in Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971).

With respect to the effect on Birnbaum of the Supreme Court decision in Bankers Life, Judge Tenney succintly held:

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* See, e.g., Lowenfels, Demise of Birnbaum Doctrine: A New Era for Rule 10b-5, 54 Va. L. Rev. 268 (1968).

** See, e.g., cases cited infra at 25.

"The Supreme Court decision in Superintendent of Insurance of New York v. Bankers Life & Cas. Co. [supra] does not, as Frigitemp argues, eliminate that requirement. Haberman v. Murchison, 468 F.2d 1305, 1311 n.5 (2d Cir. 1972); GAF v. Milstein, 453 F.2d 709, 721 (2d Cir. 1971), cert. denied, 406 U.S. 910 (1972)." (A 193a)

The facts of the Haberman case cited above illustrate the operation of the Birnbaum rule and its continuing vitality. That case involved a number of stock transactions which took place during a struggle for control of the Alleghany Corporation ("Alleghany"). Certain directors and officers of Alleghany entered into agreements with a third party, one to sell and another to repurchase a large block of Alleghany stock. Thereafter, plaintiff, an Alleghany shareholder, brought a derivative action against the selling directors claiming that the company had a right of recovery against them under § 10(b) and Rule 10b-5 as a result of these transactions as they had been consummated by defendants while in possession of "material inside" information not available to other Alleghany stockholders.

This Court, in affirming the district court's dismissal of the shareholder's action, explained the rule thusly:

"...Section 10(b) and Rule 10b-5 afford protection only to those who actually purchase or sell securities to their loss in reliance upon the withholding or misrepresentation of material information or other manipulative or deceptive

devices. . . . Neither appellant nor Alleghany, on whose behalf this action was brought and for whom alone damages are sought, falls remotely within that class." 468 F.2d at1311,1312 (Citations omitted) (Emphasis added)

In addition, the Court in Haberman noted:

"Nothing in the Supreme Court's opinion in Supt. of Insurance of New York v. Bankers Life and Cas. Co., 404 U.S. 6, 92 S. Ct. 165, 30 L. Ed. 2d 128 (1971), is to the contrary. Although the Court there reversed this court's holding that Section 10(b) extended only to fraudulent or manipulative sales and not to the fraudulent appropriation of the proceeds of a sale, it in no way suggested a rejection of the rule that a plaintiff under Section 10(b) must be a party to the sales transaction." 468 F.2d at 1311, n.5 (Emphasis added)

In the case at bar, even assuming arguendo that the Funds violated § 10(b) and Rule 10b-5 by purchasing Frigitemp common stock while in possession of material inside information, as Frigitemp was neither a seller nor purchaser of its own stock in the open market during this period, it has no standing to assert a claim based upon such transactions.

In its brief to this Court, Frigitemp attempts to circumvent the deficiency of its § 10(b) claim and the import of Judge Tenney's decision by pointing to its sale to FVF of $1,000,000 debentures and warrants in the Private Placement. (Appellants' Brief at 17) However, as no fraud, deception or even unfairness of terms has been alleged by

Frigitemp in connection with the Private Placement, it clearly cannot serve as the basis for a § 10(b) claim.

Courts have held that where a plaintiff seeks to qualify for standing under Birnbaum through its participation in a related transaction, that securities transaction must have played an intrinsic part in an overall scheme to defraud. Superintendent of Insurance v. Bankers Life & Cas. Co., supra; Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra. And where a close nexus cannot be made out, plaintiff will be barred from recovery. Bolger v. Laventhol, Krekstein, Horwath & Horwath, supra; see also Fershtman v. Schectman, 450 F.2d 1357 (2d Cir. 1971), cert. denied, 405 U.S. 1066 (1972)

In Bolger, plaintiffs were limited partners in an investment parnership. They brought an action for damages under Rule 10b-5 against the general partners and two accounting firms alleging that because of the issuance of false and misleading financial reports, they had taken no steps to recover their investment in the partnership for over a year. In attempting to meet the purchase-seller requirement of Birnbaum, plaintiffs claimed that, immediately on discovery of defendants' fraudulent activity, plaintiffs sought dissolution of the partnership, and thus the fraud (the misleading financial reports) was "directly connected" to the "sale" (the dissolution).

possibility of a merger.

In rejecting this position, Judge Metzner in Bolger distinguished the facts of the case before it from the line of cases in which many circuits have allowed standing to sue under § 10(b) where plaintiffs have been deliberately and specifically induced into holding on to their securities by misrepresentations.* The court granted defendants' Rule 12(b)(6) motion to dismiss, holding that:

> "In order to satisfy the new 'touch' test enunciated in Bankers Life, for determining if the 'in connection with' requirement has been met, the securities transaction must have played some part in the overall fraudlent scheme. The plaintiffs' sale here [the dissolution] was not part of the defendants' overall scheme to defraud the limited partners out of their investments." 381 F. Supp. at 267 (Citation omitted)

In the instant case, the only "connection" between the Funds' market purchases (from which Frigitemp claims damages) and the Private Placement (with which it seeks to qualify under Birnbaum) is a totally unsubstantiated charge of a "scheme to defraud." Such conclusionary statements are, of course, insufficient to support a 10b-5 claim. Schlick v. Penn-Dixie Cement Corp.,

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* See, e.g., Manor Drug Stores v. Blue Chip Stamps, 492 F.2d 136 (9th Cir. 1974), cert. granted, ___ U.S. ___, 42 L. Ed.2d 264 (1974); Travis v. Anthes Imperial Ltd., 473 F.2d 515 (8th Cir.1973).

defendants, as fiduciaries, were obligated to

507 F.2d 374, 378 (2d Cir. 1974), petition for cert. filed (March 13, 1975) (No. 74-1155). In fact, as the record shows, far from being defrauded by the Private Placement, Frigitemp was the key beneficiary thereof. The corporation received $1 million in cash, together with the reduction of 100,000 shares of its own outstanding common stock.

C. Frigitemp's § 10(b) Claim Must Be Dismissed for Failure to Allege or Show Actual Damages

It is equally clear that, under controlling authority, Frigitemp's § 10(b) and Rule 10b-5 claim against appellees must be dismissed for failure either to allege or to show actual damages. Section 28(a) of the 1934 Act, 15 U.S.C. § 78bb(a).

Frigitemp claims a right to the recovery of a variety of "profits" from appellees. (A 12a) However, the law is clear that where no actual damage can be shown, defendant's profits are not recoverable as damages under § 10(b) of the 1934 Act. Simon v. New Haven Board & Carton Co., Inc., Slip. Op., Docket No. 74-1272 (2d Cir., March 5, 1975); Haberman v. Murchison, 468 F.2d 1305 (2d Cir. 1972); Abrahamson v. Fleschner, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,028 (S.D.N.Y. 1975); cf. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155

(1972). (Where actual damages are shown, the defrauded plaintiff is entitled to defendant's profit if such equals more than plaintiff's loss.) See also Levine v. Seilon, Inc., 439 F.2d 328 (2d Cir. 1971).

In Haberman, appellant shareholder claimed a corporate right to appellees' alleged profits for a violation of § 10(b) citing as authority for such right SEC v. Texas Gulf Sulphur Co., 446 F.2d 1301 (2d Cir.), cert. denied, 404 U.S. 1005 (1971). In rejecting appellant's claim, this Court held:

> "[T]he essence of the 10b-5 violation in Texas Gulf Sulphur was the wrong done by the defendants to sellers on the open market not privy to the same material information. While there may be a parallel right, under state law, in the corporation to recover profits from insiders who use inside information to their own advantage, see Diamond v. Oreamuno, 24 N.Y.2d 494, 301 N.Y.S.2d 78, 248 N.E.2d 910 (1969), there is no such derivative right under federal law." 468 F.2d at 1312 (Emphasis added)

Frigitemp seeks reimbursement for its costs in defending a purported class action. (A 12a) Such costs are equally not recognizable damages under the 1934 Act. Madigan, Inc. v. Goodman, 357 F. Supp. 1331 (N.D. Ill. 1973), rev'd on other grounds, 498 F.2d 233 (7th Cir. 1974).

Frigitemp's [illegible] damage claim seeks punitive damages. (A 12a) Punitive damages are clearly not recoverable under § 10(b) of the 1934 Act or Rule 10b-5 thereunder. Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), cert. denied,

395 U.S. 977 (1969); Globus v. Law Research Service, Inc., 418 F.2d 1276 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970); Midland Investment Co. v. Van Alstyne, Noel & Co., 59 F.R.D. 134 (S.D.N.Y. 1973).

Frigitemp's failure to show actual damages, coupled with the Funds' substantial realized losses in Frigitemp securities, leaves Frigitemp with no possibility of a monetary recovery in this action and, accordingly, its claim based upon the anti-fraud provisions of the 1934 Act should be dismissed.

POINT II

THE DISTRICT COURT WAS CORRECT IN DISMISSING ALL CLAIMS OF THE INDIVIDUAL APPELLANTS

A. Individual Appellants Lee, Ross and the Guttmans Have No Claim for Fraud Under § 10(b) of the 1934 Act Based Upon Their Contribution to Capital of 100,000 Shares of Frigitemp Common Stock

The individual appellants claim a right to $2.1 million in damages as defrauded sellers under § 10(b) of the 1934 Act and Rule 10b-5 thereunder. President Lee, Treasurer Ross and the Guttmans claim that, in connection with the Private Placement with appellee FVF, consummated on August 29, 1969, they were "induced" to contribute an aggregate of 100,000 shares back to Frigitemp capital by the appellees, who, to that end, failed to disclose to

appellants (a) that they "were causing and had caused" the Funds to acquire Frigitemp common stock,* and (b) that the contribution to capital by Lee, Ross and the Guttmans would inure to the financial benefit of the Funds.

Appellants' conclusionary claim is not only audaciously misleading, but wholly unsupported by governing law. An analysis of the facts as alleged in the complaint and as set forth in appellants' supplementary affidavits shows that certain basic elements of fraud necessary to establish a claim under § 10(b) simply do not exist in this case.

As a general proposition, federal courts have required a showing of four elements to support a Rule 10b-5 claim: deception, causation, materiality and reliance. List v. Fashion Park, Inc., 340 F.2d 457 (2d Cir.), cert. denied, 382 U.S. 811 (1965) petition for rehearing denied, 382 U.S. 933 (1965); Devonbrook, Inc. v. Lily Lynn, Inc., [1973-1974 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,621 at p. 96,205 (S.D.N.Y. 1974). Recently, however, in cases charging nondisclosure, the requirements of causation, reliance and materiality have merged and, in their stead,

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* In their brief to this Court, appellants now allege nondisclosure of appellees' "intention to continue these purchases and to corner and manipulate the market." (Appellants' Brief at 21.)

the "causation in fact" standard has been applied to determine whether a valid claim under Rule 10b-5 has been shown. See Affiliated Ute Citizens v. United States, supra;* Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra. As the Supreme Court stated the "causation in fact"

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* In a recent decision, this Court held that the Supreme Court's holding in Affiliated Ute, supra, did not read out reliance as a requisite element in a Rule 10b-5 action involving alleged non-disclosures. In Titan Group, Inc. v. Faggen, Slip. Op., Docket No. 74-1694 (2d Cir., April 1, 1975), this Court set forth a cogent interpretation of the judicial requirements of reliance and materiality imposed under § 10(b):

> "[T]he Court, [in Ute] rather than abolishing reliance as a prerequisite to recovery, was recognizing the frequent difficulty in proving, as a practical matter, that the alleged misrepresentation, allegedly relied upon, caused the injury. The parallel elements of materiality and reliance both serve to restrict the potentially limitless thrust of Rule 10b-5 to those situations in which there exists a causation in fact between the act and injury. Globus v. Law Research Service, Inc., 418 F.2d 1276 (2 Cir. 1969), cert. denied, 397 U.S. 913 (1970), List v. Fashion Park, Inc., 340 F.2d 457 (2 Cir.) cert. denied, sub. nom. List v. Lerner, 382 U.S. 811 (1965). Causation remains a necessary element in a private action for damages under Rule 10b-5....
>
> In cases involving non-disclosure of material facts, even when coupled with access to the information, materiality rather than reliance thus becomes the decisive element of causation. See, e.g., Metro-Goldwyn-Mayer, Inc. v. Ross, _____ (2d Cir. 1975), Dkt. No. 73-2271, Slip. op. at 1315; Stier v. Smith, 473 F.2d 1205 (5th Cir. 1973). And determination of materiality allows logically an inference of reliance. Chris-Craft Industries Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2 Cir.), cert. denied, 414 U.S. 910 (1973). See, generally, Note, 88 Harvard L. Rev. 584 (1975)." Slip. Op. at 2669, 2670.

test in the Affiliated Ute case:

> "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision . . . . This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." 406 U.S. at 153-54 (Citations omitted) (Emphasis added)

However, the "causation in fact" standard has been developed by the courts, and must be applied by them, to further, not thwart, the underlying legislative purpose of § 10(b) and Rule 10b-5. As one authority has stated:

> "The problem in the silence cases is to identify the circumstances which trigger a duty to come forward with information. In the rule 10b-5 context the concept of materiality appears to be applied more restrictively in imposing liability for failure to fulfill an affirmative obligation to disclose than in imposing liability with respect to a misstatement or half-truth. . . . A responsibility to come forward with information has typically been imposed only where the undisclosed event has a significant and long-term impact on the company." Fleischer, Jr., Mundheim, Murphy, Jr., An Initial Inquiry into the Responsibility to Disclose Market Information, 121 U. Penn. L. Rev. 798, 803 (1973) (Emphasis added)

In a recent application of the "causation in fact" rule, this Court in Shapiro v. Merrill Lynch, Pierce, Fenner & Smith, Inc., supra, reiterated the legislative purpose which the rule is to enhance:

"'[T]he essential purpose of Rule 10b-5 . . . is to prevent corporate insiders and their tippees from taking unfair advantage of the uninformed outsiders.'" 495 F.2d at 235 (Citation omitted)

Thus, although the definition of "inside information" has been judicially expanded (as appellants have indicated) to include certain "market information" as well as strictly "corporate information,"* federal courts have found a valid claim for nondisclosure only where (i) the information was indeed inside in nature, and (ii) where the defendant was found, in fact, to have had a duty to disclose such information. E.g., Affiliated Ute Citizens v. United States, supra; Metro-Goldwyn-Mayer, Inc. v. Ross, 509 F.2d 930 (2d Cir. 1975); Chasins v. Smith, Barney & Co., 438 F.2d 1167 (2d Cir. 1971); cf. In Re Republic National Life Insurance Co., and Realty Equities Corp., 387 F.Supp. 902 (S.D.N.Y. 1975). (Defendants who engaged in a financial reporting service were held to have no duty to investigate or verify financial information submitted to them for publication by a

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* For a discussion of these terms, see Fleischer et al., supra, 121 U. Penn. L. Rev. at 799.

corporation, even though they had recommended that corporation's stock as a sound investment.)

The facts of the Affiliated Ute case are illustrative. Plaintiffs, because of their membership in the Ute Indian tribe, owned shares in a corporation set up to manage and realize on substantial rights belonging jointly to the tribe. After selling their shares, plaintiffs filed suit against the bank which served the corporation as transfer agent and certain of its employees claiming damages under § 10(b) and Rule 10b-5. It was alleged that while encouraging plaintiffs to sell, defendants had failed to disclose that they (i) were active in encouraging a market for the corporation's stock among non-Indians, and (ii) received substantial commissions and fees for the market they were actively soliciting.

The Court held that if the bank and its employees had functioned merely as a transfer agent, there would have been no duty to disclose. 406 U.S. at 152. However, as the bank and its employees had assumed, in written agreements, substantial duties with respect to advising plaintiffs on various aspects of their stock (including price), the Court found liability for nondisclosure. It stated:

> "The individual defendants, in a distinct sense, were market makers, not only for their personal purchases constituting 8-1/3% of the

> sales, but for the other sales their activities produced. . . . The defendants may not stand mute while they facilitate the mixed-bloods' sales to those seeking to profit in the non-Indian market the defendants had developed and encouraged and with which they were fully familiar. The sellers had the right to know that the defendants were in a position to gain financially from their sales and that their shares were selling for a higher price in that market." 406 U.S. at 153 (Emphasis added)

The principal rationale for the imposition of a duty of disclosure was reiterated by this Court in Chasins v. Smith, Barney & Co., supra. In that case, a stockbrokerage firm was held liable to a customer, who had purchased certain securities from it and on its recommendation, for failing to disclose that the firm was "making a market" in the securities involved. The Court of Appeals held that:

> "[D]isclosure of [these] fact[s] would indicate the possibility of adverse interests which might be reflected in Smith, Barney's recommendations. . . . The investor, such as Chasins, must be permitted to evaluate overlapping motivations through appropriate disclosures, especially where one motivation is economic self-interest. 438 F.2d at 1172 (Emphasis added)

No duty to disclose can be imposed on the facts as are alleged in the instant case. Plaintiffs-appellants, executive officers and major stockholders of Frigitemp, are the corporate insiders here; defendants-appellees, the Funds, were merely investors in Frigitemp stock. No "inside" infor-

mation bearing on the Private Placement was withheld. No undisclosed possibility of adverse interests running to any of the appellees existed which might bring the appellees within the prohibitions of § 10(b), as interpreted by the above authorities.

On August 29, 1969, Lee, Frigitemp's chief operating executive and controlling shareholder, and its Treasurer, Ross, among others, entered into a deal on behalf of the corporation pursuant to which Frigitemp received a $1 million investment in cash and they, together with the other appellant stockholders, agreed to return to capital an aggregate of 100,000 shares of their substantial personal holdings in Frigitemp common stock.

By that date, however, as Judge Tenney noted (A 194a), appellants knew or should have known that the Funds had become substantial stockholders in Frigitemp, in that they had acquired during the period from March to August, 98,600 of the total 142,100 shares which they allegedly purchased. (See supra, at 11 n.) As Lee, Ross and the Guttmans were not only substantial stockholders of Frigitemp, but also either officers and directors or senior employees of the corporation, the stock ledger of Frigitemp was freely available to each. Thus, each one had detailed infor-

mation available to him concerning the Funds' stock purchases up until the date of the Private Placement.*

The appellants (according to their own statements) did not bother to avail themselves of the information in the stock ledger book before agreeing to relinquish their stock, simply points up the obvious fact that such information was of no relevance to their investment decision. As President Lee stated:

> "Prior to January, 1971, neither I nor any other officer of Frigitemp ever looked at its daily stock transfer records, much less took the trouble to calculate from each daily record, the number of Frigitemp shares being acquired in the open market by any person . . . . My family and I firmly controlled Frigitemp through ownership of approximately 59% of its outstanding stock. I had no reason to care what Frigitemp's stock transfer sheets might have shown about accumulations of shares by others." (A 140, 141a) (Emphasis added)

Lee thus admits what the facts clearly show: given the limited number of outstanding shares of Frigitemp stock available to the public, the identity of the public shareholders, present or future, was virtually irrelevant to the investment decision of the individual

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* Equally available, of course, was the market price increase which is alleged to have been caused by the Funds' Frigitemp stock purchases.

appellants. Accordingly, the Funds, had no duty to disclose whatever intentions they might have had in August 1969 with respect to future purchases of Frigitemp stock.

The inverse rule of law to that which imposes a duty to disclose material inside information, is that which holds that where the information claimed to have been fraudulently withheld is either tangential to or remote from the security transaction involved, a plaintiff's 10b-5 claim thereon will not be sustained. List v. Fashion Park, Inc., supra; Nanfito v. Tekseed Hybrid Co., 473 F.2d 537 (8th Cir. 1973); Lewis v. Adler, 331 F. Supp. 1258, 1265 (S.D.N.Y. 1971); compare Birdman v. Electro-Catheter Corp., 352 F. Supp. 1271 (E.D. Pa. 1973). And, of course, as Judge Tenney held, where the nondisclosed information is actually or constructively known to plaintiff, plaintiff will be barred from recovery. Johnson v. Wiggs, 443 F.2d 803, 806 (5th Cir. 1971); Jackson v. Oppenheim, [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 94,894 at pp. 97,041, 97,042 (S.D.N.Y. 1974); Harnett v. Ryan Homes, Inc., 360 F. Supp. 878, 886 (W.D. Pa. 1973), aff'd, 496 F.2d 832 (3d Cir. 1974).

The facts in List v. Fashion Parks, Inc., supra. are instructive on this point. In List, plaintiff, a minority shareholder in a corporation, brought suit against the corporation, certain of its directors and officers,

and an outside brokerage firm. He claimed a right to damages under § 10(b) allegedly suffered from the sale of his stock to a director of the corporation at a time when the director and his stockbroker were in possession of undisclosed material inside information. It was alleged that defendants had failed to disclose to plaintiff (i) the identity of the purchaser as a director of the company, and (ii) that the company had resolved to sell or to merge. Shortly after the sale, the corporation entered into a merger agreement pursuant to which plaintiff would have received more than double the price which he in fact received for his stock.

In its opinion, the Court of Appeals noted the findings of the trial court: that plaintiff was an experienced investor, had actively solicited the sale of his own stock, and had not asked his broker the identity of the purchaser. Noting further that plaintiff had been desirous of making the five-point profit which he in fact made on the sale, and had relied on his extensive dealings in the securities field, the Court concluded "that the identity of the buyer would have been of little or no concern to him." 304 F.2d at 464. In affirming the dismissal of plaintiff's 10b-5 claim, the Court concurred with the trial court that <u>the identity of the purchaser</u> and the

possibility of a merger was information too remote under these circumstances to have influenced the conduct of a reasonable investor. The Court in List stated the now familiar rule with respect to materiality:

> "The proper test is whether the plaintiff would have been influenced to act differently than he did act if the defendant had disclosed to him the undisclosed fact. . . . To put the matter conversely, insiders 'are not required to search out details that presumably would not influence the person's judgment with whom they are dealing.' . . . This test preserves the common law parallel between 'reliance' and 'materiality,' differing as it does from the definition of 'materiality' under Rule 10b-5 solely by substituting the individual plaintiff for the reasonable man." 340 F.2d at 463 (Citations omitted) (Emphasis added)

The reasonable man test was likewise applied by the Eighth Circuit Court of Appeals in Nanfito v. Tekseed Hybrid Co., supra. In Nanfito, the administrator of a deceased shareholder in a closely held corporation brought suit against the corporation and its directors claiming damages under Rule 10b-5 for, inter alia, nondisclosure to the deceased of all relevant facts in connection with a merger. The merger, between the defendant corporation and another inoperative corporation owned by the same shareholders, had been approved by all shareholders. The effect of the merger was to reduce the deceased's proportionate interest

in the surviving corporation from 20% to 14.71%. Plaintiff claimed that defendants, as fiduciaries, were obligated to inform the deceased as to the reasonable value of the stock of the merged corporation or alternatively to inform her of the value of the assets and a reasonable capitalization rate of earnings.

The Court of Appeals rejected appellants' position and affirmed the lower court's decision in favor of defendants. It held:

> "Under these circumstances, we think that the court correctly held that no material information was withheld from [the deceased] and that [the deceased] was fully competent to take the information that was made available to her and to determine from that the effect which the merger would have on the value of her interest in the corporation.
>
> "In support of his position, the plaintiff relies on the following cases: Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66 (E.D.N.Y. 1969); Baumel v. Rosen, 283 F. Supp. 128 (D. Md. 1968), modified, 412 F.2d 571 (4th Cir. 1969), cert. denied, 396 U.S. 1037 90 S.Ct. 681, 24 L. Ed.2d 681 (1970); Speed v. Transamerica Corporation, 71 F. Supp. 457 (D. Del. 1947). We believe, however, that they are inapposite as each of them involves a situation in which insiders concealed facts which would have materially affected the value of the stock. There was no such concealment here." 473 F.2d at 542 (Emphasis added)

In contrast to the circumstances in the List and Nanfito cases, are those in Birdman v. Electro-Catheter Corp., supra, upon which appellants rely. In that case,

plaintiff purchased stock in the defendant corporation pursuant to a public offering. He claimed damages under § 10(b) and Rule 10b-5 stating that the prospectus on which he had relied had failed to mention the probability that certain holders of unregistered stock intended to sell their shares (an amount equal to 25% of the public offering) shortly after the public offering. The district court held that plaintiff's allegation that the omission of information concerning the imminent sale of unregistered stock (of which defendant corporation "knew to a near certainty" 352 F. Supp. at 1274) misled him as to the number of shares available to the public in the after-market, stated a claim recognizable under §10(b) and Rule 10b-5.

In the instant action, the circumstances as alleged by appellants are such as to demand dismissal of appellants' claims under the principles enunciated in List, Nanfito and Birdman. Most importantly and in contrast to these cases, Lee, Ross and the Guttmans are the corporate insiders suing outsider-investors for non-disclosure of certain information which relates solely to the stock of their own corporation. As such, appellants had all the facts necessary to make an informed judgment on their investment decision concerning the Private Placement. As of

August 29, 1969, Lee, Ross and the Guttmans either knew or should have known (i) that the Funds with whom they were negotiating were substantial stockholders of Frigitemp common stock and had been buying Frigitemp stock since March of that year (compare List); (ii) that the market price of Frigitemp stock had risen during that period; (iii) that the Funds might well continue to purchase Frigitemp stock; and (iv) that, just as they themselves would benefit from a reduction in the outstanding Frigitemp stock in an amount proportionate to the size of their holdings, so too would the Funds benefit in proportion to the size of their holdings. As executive officers, directors of the corporation, Lee and Ross were well aware of the total number of shares of Frigitemp stock which were or might be available for purchase by the public (compare Birdman).

The Funds were dealing with appellants at arm's length. They had a right to assume that the executive officers of Frigitemp knew the stockholders of record of their own company. If, as this Court has stated in List v. Fashion Park, Inc., supra, "insiders are not required to search out details that presumably would not influence the person's judgment with whom they are dealing" (340 F.2d at 463), surely an outsider cannot be held to a higher standard of disclosure.

To so read the requirements of § 10(b) and Rule 10b-5 would be clearly untenable. To impose a duty to disclose intentions as to future stock purchases would require every investor to determine, at the time of purchasing stock, how much stock he thereafter intended to purchase. For example, if the Funds were legally obligated to disclose an intent to make additional purchases of Frigitemp stock, how much more information would they have to disclose to be in compliance with the law? Would they have to specify when they would purchase? How many shares? How high a price they would be willing to pay? And what if a good faith business decision were made thereafter not to purchase, but to sell? Would they not be open to a justifiable claim that they had misrepresented their "present intention" to purchase? The law is not so capricious.

As Judge Tenney held, under the facts as are alleged herein, information concerning present intention to make future purchases of Frigitemp stock was not inside information -- "corporate," "market" or otherwise. The Funds and their agents were neither insiders nor "market-makers." To the contrary, with respect to the value of Frigitemp securities (which was at the crux of the Private Placement), it was appellants, not appellees, who were the insiders. As such, they had no right to the irrelevant

information the nondisclosure of which forms the basis of their claim.

B. Individual Appellants Have No Action for Fraud Under New York Law for Alleged Nondisclosures

Lee, Ross and the Guttmans claim a common law right to recover alleged damages because of appellants' nondisclosures with respect to their past purchases of Frigitemp stock and "their intentions with respect to future purchases." (Appellants' Brief at 26) This final claim is equally devoid of any merit and clearly unsupported by governing law.

As Judge Tenney held, nondisclosure is not actionable under the common law of fraud and deceit unless there is a duty to speak. (A 192a) That duty may arise when plaintiff and defendant are in a confidential, fiduciary relationship, when defendant has notice that plaintiff is acting upon a mistaken belief as to a material fact, or when defendant resorts to misrepresentation or some other artifice aimed at preventing disclosure of the facts. See, e.g., Amend v. Hurley, 293 N.Y. 587, 596 N.Y.S.2d (1944); Wood v. Amory, 105 N.Y. 278, 281-82 (1887); People's Bank v. Bogart, 81 N.Y. 101, 107-08 (1880); Warren Bros. Co. v. New York State Thruway Authority, 34 App. Div.

2d 97, 99, 309 N.Y.S.2d 450, 452 (3d Dep't 1970), aff'd, 34 N.Y.2d 770, 358 N.Y.S.2d 139 (1974); Moser v. Spizzirro, 31 App. Div. 2d 537, 295 N.Y.S.2d 188, 188-89 (2d Dep't 1968), aff'd, 25 N.Y.2d 941, 305 N.Y.S.2d 153 (1969); Dash v. Jennings, 272 App. Div. 1073, 1074, 74 N.Y.S.2d 881, 883 (2d Dep't 1947).

In Wood v. Amory, supra, the New York Court of Appeals held that:

> "There must be some relation of trust and confidence existing between the parties upon which to build the duty to disclose before the right to a disclosure can be enforced by the courts." 105 N.Y. at 282

The court went on to state that a conspiracy to remain silent is not unlawful

> "[w]ithout going further and showing that the concealment was but one step in carrying out a conspiracy which was unlawful . . . . Mere general allegations of fraud or conspiracy are of no value as stating a cause of action." Id.

Appellants attempt to construct some sort of fiduciary relationship between Frigitemp and the Funds which might impose upon one or all of them some duty to disclose something to someone. (Appellants' Brief at 25) Such factual and legal conclusion, however, is simply not supported by the facts as alleged. The pleadings only show that one of the Funds dealt at arm's length with

Frigitemp and its officers and directors in negotiating the terms of the Private Placement. Fiduciary status does not spring from such a relationship.

Thus, as Judge Tenney correctly held,

> "Since nondisclosure of material facts is all that is alleged in support of this claim, it must likewise be dismissed for failure to state a claim." (A 197a)

POINT III

THE COMPLAINT SHOULD BE DISMISSED FOR FAILURE TO STATE THE CIRCUMSTANCES OF THE ALLEGED FRAUD AND CONSPIRACY WITH PARTICULARITY

Rule 9(b) of the Federal Rules of Civil Procedure reads in part as follows:

> "In all averments of fraud or mistake, the circumstances constituting fraud or mistake shall be stated with particularity."

It is settled law in this Circuit that the requirements of Rule 9(b) extend to allegations of securities law fraud under Section 10(b) of the 1934 Act. Felton v. Walston and Co., Inc., 508 F.2d 577 (2d Cir. 1974); Segal v. Gordon, 467 F.2d 602 (2d Cir. 1972); Shemtob v. Shearson, Hammill & Co., 448 F.2d 442 (2d Cir. 1971); Bell v. J. D. Winer & Co., Inc., [Current Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 95,002 at p. 97,473 (S.D.N.Y. 1975).

The complaint in this action has failed utterly to comply with these requirements. Each cause of action indiscriminately incorporates by reference all preceding paragraphs, making it possible only to speculate as to which alleged acts support which claims. In addition, the complaint states conclusions spanning extensive (and inconsistently described) time periods such that it is impossible to determine which defendants are alleged to have committed what acts and at what time.

For example, paragraph 17 of the complaint states that the defendants obtained "inside" information. The individuals who gave the defendants that information are not identified. The only allegation as to when the information was given is "[a]t and prior to the time of the aforesaid open market purchases of the common stock and in connection with the Private Placement...." (A 7a) This would limit the period in question to between March 1969 (when the purchases allegedly began) and August 29, 1969 (date of Private Placement agreement). (A 6a, 7a) Yet, as noted supra at 11, subparagraphs (c), (d) and (e) of the complaint make reference to "inside information" allegedly disclosed during this period which relates to acquisitions completed on October 1969, June 1970 and November 1969, each several months after

the termination of the disclosure period. (A 8a) Thus, the complaint is self-contradictory.

The conspiracy allegations against the Funds and others reduce themselves to this: the Funds bought Frigitemp securities and the price went up; the Funds sold Frigitemp securities and the price went down. As this Court noted in Segal, supra:

> "The word 'conspiracy' does not alone satisfy the specificity requirement of Rule 9(b). A complaint cannot escape the charge that it is entirely conclusory in nature merely by quoting such words from the statutes as 'artifices, schemes, and devices to defraud' and 'scheme and conspiracy.'" 467 F.2d at 608 (Citations omitted)

The Court also stated:

> "It is a serious matter to charge a person with fraud and hence no one is permitted to do so unless he is in a position and is willing to put himself on record as to what the alleged fraud consists of specifically. [Citing 1a W. Barron & A. Holtzoff, Federal Practice and Procedure § 302, at 215-16 (Wright rev. 1960).]
>
> "In response to these considerations, this Court and our lower courts have been sensitive to the requirement that the circumstances constituting fraud be alleged with particularity. . . . '[T]here must be allegation of facts [in a complaint under Rule 10b-5] amounting to deception in one form or another; conclusory allegations of deception or fraud will not suffice' O'Neill v. Maytag, 339 F.2d 764, 768 (2d Cir. 1964) . . . ." Id. at 607 (Citations omitted) (Emphasis added)

Allegations of fraud have serious repercussions in the business world and should not be cavalierly couched in boilerplate phrases as appellants have done. They have totally failed to plead any facts which might support their conclusory charges of fraud and conspiracy.

CONCLUSION

The District Court's order dismissing all appellants' claims should be affirmed in all respects.

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Respectfully submitted,

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S/ Two Copies Rec'd of Page viii
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